THE DEVELOPMENT BY COMMISSIONS OF THE PRINCIPLES OF PUBLIC UTILITY CAPITALIZATION

The laws of a number of states impose upon the public service commissions the duty of regulating the issuance of securities by utility corporations, and provide that the approval and consent of the commission shall be necessary before any stocks, bonds, or evidences of indebtedness shall be issued. All of the commissions regulating capitalization, except those of Massachusetts and Texas, have been established since 1907. In general, the laws provide that the commission shall approve only such issues of securities as it shall deem reasonably necessary for certain purposes. The purposes generally specified in the laws are the acquisition of property, the construction or extension of facilities, the improvement or maintenance of the service, and the discharge or refunding of lawful obligations. While the laws differ in wording and in detail the principle apparently common to all is that securities shall be issued only in such amounts as shall be necessary for purposes properly chargeable to capital account. As will be seen, the commissions are necessarily intrusted with a large measure of power and discretion. What expenditures should properly be capitalized? Under what circumstances should the issuance of securities be approved? Upon what terms should securities be disposed of? These and questions of like importance must be passed upon by the commissions. If control of capitalization is to be vested in the state, it is essential that it shall rest upon sound principles. It is therefore of importance to inquire concerning the principles of public utility capitalization which are being developed by the various commissions. This paper will describe the attitude taken upon several important questions by some of the leading commissions.

CORPORATIONS ALREADY OVERCAPITALIZED

Presumably, the chief purpose of regulation of capitalization is to establish an equilibrium between the capitalization and the bona fide investment. But regulation of securities has been

practiced only a few years. What, then, is to be done when a corporation which was already heavily overcapitalized prior to the establishment of commission control applies for permission to issue new securities, the purposes for which the new securities are to be issued being legitimate and proper? Is such a corporation to be permitted to issue new securities to construct an addition to its property; or is it to be denied this privilege until it brings the value of its existing property up to the value of its present outstanding capitalization?

The New York Second District Commission early in its history, was compelled to pass upon this question, and it did so by turning its back upon the past deeds and misdeeds of the corporations. The Commission holds that it has absolutely nothing to do with the capitalization of the companies which had come about previous to its establishment. It maintains that its duty is simply to pass upon applications for new securities, and to determine whether new capital to be issued is for purposes which are right and proper under the law. It holds that purchasers of securities approved by the Commission are not exempt from the risks involved in the possibility of the corporation being overcapitalized.[1] The Public Service Commission of Ohio, in its first report, deals with this problem, and boldly announces its future policy as follows:

> When enterprises have been established under methods of finance common in former days, which resulted in overcapitalization, and when such enterprises have sought permission further to increase an already fictitious capitalization . . . . the Commission has held to the idea that past derelictions of duty or offenses involving even moral turpitude should not be regarded as a bar to future honest action, although the honest superstructure may of necessity be compelled to rest upon a dishonest foundation. The Commission has, therefore, permitted, in proper cases, the future capitalization of enterprises already admittedly overcapitalized, it being considered better to improve in any degree a bad condition than to permit its continuance without hope of improvement.[2]

The New Jersey Commission takes the same position, and holds that the intent of the public utility law is "to prevent subsequent

[1] In the matter of Watertown Light & Power Co., P.S.C. Reports, Second District, New York, I, 146.

[2] Report of the Public Service Commission of Ohio, 1912, p. 4.

inflated issues."[1] Although most of the other commissions have not explicitly committed themselves on this issue, the position of the above-named commissions appears to be that tacitly taken by the commissions of the other states, with the exception of those of Massachusetts and Texas. For most of the commissions, including those of Indiana, Maryland, Nebraska, Michigan, Illinois, New Hampshire, Wisconsin, California, and Missouri, approve new issues of securities, regardless of the relation between capitalization outstanding and the value of existing property.

But in Massachusetts and Texas a different policy has been followed. The general practice of the Massachusetts Board of Gas and Electric Light Commissioners has been to refuse its approval to new securities when the value of the property of the company is less than the par value of stock and funded debt outstanding. When this Commission was first given the right to regulate securities (1894), the companies insisted that it should concern itself only with existing conditions and needs, regardless of past capitalization. The Commission however rejected this theory, upon the ground that the legislature had given it discretion as to the conditions upon which it would approve new securities; and it established the principle that overcapitalized companies would not be permitted to issue additional securities. This is, however, to be regarded merely as the statement of a general policy, as the Board has found it necessary in some instances, in the immediate public interest, to waive this rule. The new Public Service Commission of Massachusetts announces[2] that it will not permit further capitalization "even if the expenditures are legitimate and lawful," when overcapitalization already exists. The Texas Railroad Commission, under the direction of the state law, has regularly refused to permit new issues of securities to be made if the outstanding issues exceed the value of the property owned,[3] although the harshness of this practice has been lessened by permitting the separate capitalization of extensions.

[1] State of New Jersey, Board of Public Utility Commissions, Conference Order No. 7, and Conference Ruling No. 13.

[2] Personal letter to author, March 4, 1914.

[3] Report of the Texas Railroad Commission, 1913, p. 442.

Which of these principles should be applied? It is evident that if the commissions grant permission to issue new securities to companies already overcapitalized, it will be only the new corporations which have come into existence since the régime of regulation which will be compelled to maintain an equivalence between capitalization and investment in property, and that this condition may not be brought about with the older corporations which were already overcapitalized before regulation of securities began. But to ask the commissions to follow the practice of the Massachusetts commissions, and squeeze out all the water which has been injected in the past before new securities may be issued, would be to impose a tremendous task, one which would be accompanied by great financial hardship to many corporations and individuals. This principle appears to violate the elementary theories of American justice and to establish an *ex post facto* practice, compelling in substance the elimination of capitalization the issuance of which was perfectly legal and was countenanced by the states at the time it was made. It is a policy which, if rigidly enforced, will tend to deprive the public of needed extensions and improvements on the part of overcapitalized companies, which might not desire to issue additional securities in order to increase their facilities, if, to do so, they must first forego dividends in order to bring their property value up to existing capitalization, or scale their capitalization down to correspond to the value of their property. It is well known that the rigid application of this policy in Texas has checked the building of extensions and investments in betterments of the railroads. In Massachusetts this result has been largely prevented by the fact that the Gas and Electric Light Commission has permitted the establishment of rates which would enable the companies to build up a surplus in the property out of earnings. Furthermore, the commissions more recently established in other states would find the task of applying this principle much more difficult than the Massachusetts Gas and Electric Light Commission and the Texas Railroad Commission found it, for regulation of securities in both of these states began at a comparatively early date. It would seem that ordinarily the new commissions should confine themselves to seeing to it that securities now issued are for proper purposes and in

proper amounts, without endeavoring to extend their regulatory power into the past. But ignoring past overcapitalization should not be carried so far as to permit the issuance of additional securities by corporations which are on the road to bankruptcy and which inevitably must go into the hands of a receiver; for to do so would be to inflict the probability of loss upon the purchasers of such securities. The wisdom of this principle has been recognized by the California Commission.[1]

REPLACEMENTS

Most of the state laws provide that securities may be issued for the acquisition of property but do not state that that which is acquired must represent a net addition to the property. In other words, generally speaking, the laws are silent concerning the capitalization of replacements.[2] This question therefore is one with which the commissions must deal in the exercise of their discretion.

The New York Second District Commission has unreservedly condemned the capitalization of replacements, saying: "Such a method of financing usually has but one outcome, namely, bankruptcy."[3] However, in acting upon a later application, that of the Binghamton Light, Heat & Power Company, the Commission explained that it did not take the position that under no circumstances would it approve the issuance of securities for replacements, but it insisted that if its approval were to be given, the replaced property should not continue to be carried on the books as an asset and that the accounts of the corporation must be so adjusted as to make a true showing of the affairs of the company.[4] The Commission endeavored to carry out the above-explained principles by consenting to the issuance of bonds to produce

[1] Opinions and Orders of the California Railroad Commission, II, 140.

[2] Several of the laws in permitting the capitalization of expenditures already incurred provide that such expenditures must not have been made for the purpose of operating expenses or replacements, but they do not contain this provision as to the issuance of securities to cover expenditures not yet made.

[3] Public Service Commission Reports, Second District, New York, II, 90.

[4] Application of the Binghamton Light, Heat & Power Company, Public Service Reports, Second District, New York, II, 171.

$158,000 upon condition that the company reduce its capital stock by $100,000 and credit its fixed capital with the same amount.[1] The New York First District Commission has refused to permit the capitalization of replacements, but maintains that when replacements are superior in style and capacity to the property displaced the proper standard by which to determine the amount capitalizable is the relative cost of each.[2] The Ohio[3] and California[4] commissions have also refused to permit the capitalization of replacements. The New Hampshire Commission implies that under some circumstances it might permit the capitalization of replacements, saying, "A situation may exist where we would be justified in permitting the issuance of new capital to replace portions of a depreciated plant, but we feel that such course should not be followed in the case of a utility which is in a position to render good service to the public, and which has earnings which might be devoted to any improvements that it deems for its advantage."[5]

Theoretically it is obvious that replacements should not be capitalized. The complicating factor is the circumstance that frequently adequate depreciation reserves have not been provided, whereas the need for replacement of old property is urgent. Under such circumstances one possibility is the use of the method prescribed by the New York Second District Commission, outlined above. This method is equivalent to saying that if a corporation has not in the past accumulated a depreciation reserve from which to provide for its replacements, it must expect to atone for its misconduct now. While it may be permitted to issue new securities to obtain the necessary funds for replacements, it must write out of its balance sheet the property to be replaced. Therefore in order that it should have a statement in which its capital liabilities are

[1] Upon appeal of the foregoing case the New York Court of Appeals held that it was the intent of the statute that only permanent improvements should be capitalized, that it was beyond the power of the Commission to permit the issuance of improper securities upon condition that the company reduce its capital stock. See People ex. rel. Binghamton Light, Heat & Power Company v. Stevens 203 N.Y. 7.

[2] Public Service Commission Reports, First District, New York, III, 406.

[3] Report of the Public Utilities Commission of Ohio, 1914, p. 149.

[4] Opinions and Orders of the Railroad Commission of California, II, 1026.

[5] New Hampshire Public Service Commission Reports, III, 165.

represented by true assets, it would be necessary for it to draw upon either its surplus or its future earnings. Under this method, if a company has no surplus, apparently stockholders must accept reduced dividends temporarily. Whether this is penalizing present stockholders with undue severity, because of the failure of the corporation to set aside a proper depreciation fund in the past, when such action was not required of it and before regulation of securities began, is a question which naturally gives rise to much difference of opinion.

But it is difficult indeed to suggest any method of handling this item which is likely to prove generally satisfactory. The treatment of replacement is one of the most difficult problems which confronts the commissions. Evidently, as a general rule, an effort should be made to prevent the capitalization of replacements. Nevertheless it may be more advisable to permit this in some cases than to compel the public to be served by a rundown and dilapidated property. But sound finance dictates that whenever the urgency of the situation renders it imperative to permit the capitalization of replacements, the permission should be accompanied by provision for the eventual reduction of capital liabilities or the investment of earnings in net additions to the property, by an amount equal to the replacements capitalized. Obviously the future capitalization of replacements of a plant which still has many years of wearing life can well be prevented, without interfering with the rendering of adequate service, by the commission's insistence upon the setting aside regularly of a proper depreciation fund. But during the early years of commission control, when replacement must be made which the depreciation reserve is not adequate to provide for, this whole problem will inevitably prove a troublesome one.

REWARD TO THE PROMOTER

Should the promoter of a public utility enterprise be permitted as a return for his services some of the securities approved by the Commission? This is another question upon which the commissions disagree. Both the Massachusetts Railroad Commission (now the Public Service Commission) and the Massachusetts Gas

and Electric Light Commission have refused to recognize promoter's service as something which should be capitalized. The Maryland Commission and the Ohio Commission also have not as yet allowed anything for promoter's compensation. The New York Second District Commission holds that "a fair allowance" of capitalization should properly be made for such services.[1] In authorizing the capitalization of five per cent of the estimated cost of the plant for this purpose in one case,[2] the Commission states that this is not to be regarded as a precedent, since the amount of capitalization to be authorized for this purpose should vary with the circumstances and the difficulty of the project. The New York First District Commission, the Wisconsin, Georgia, and Indiana commissions also recognize promoter's reward as a proper item for capitalization. The California Commission takes a bold stand in favor of permitting to the promoter an adequate and generous reward. This attitude is taken in a recent decision in which the Commission authorized the issuance of $27,500 of securities to defray organization expenses of the Central California Gas Company, $12,000 of which was to go to the promoter in return for his services.[3] The Commission held that payments for promoters' services and organization expenses

> are as necessary to the success of a public utility and are as properly subjects of capitalization as the cost of the component parts of the utility's plant. . . . . A public authority, in estimating the value of such services, should be liberal so that men of ability may be attracted to the development of new utility enterprises where needed for the development of the state. . . . . It may be well that in addition to a reasonable compensation for the time devoted to the work, the promoter should be allowed an additional remuneration to compensate him for his risk of failure.

No enterprise of any importance can be inaugurated without the services of a capable promoter and organizer. He is the man

[1] Public Service Commission Reports, Second District, New York, III, 166.

[2] *Ibid.*, I, 186.

[3] Opinions and Orders of the Railroad Commission of California, II, 116. For other decisions in which the California Commission specifically authorizes the capitalization of promotion expenses and services see II, 326, decision upon the application of the California, Shasta and Eastern Railway for authority to issue bonds and stock, and the decision upon the application of the San Rafael and San Anselmo Valley Ry. Co. to issue bonds, III, 879.

who sees the opportunity, who can make others see it and believe in it, who organizes the plans and pushes them to completion. To encourage the exercise of such talent, an adequate reward should be permitted by the public. If men are to be permitted only a fair return upon the actual money invested in the property without any return for the time and ability spent in organizing and planning an enterprise, for making the preliminary study of the field, for organizing and securing financial support for the project, then capital will soon forsake this field of investment. In some cases such an allowance may be unnecessary, but the propriety of an allowance can be determined by a study of the conditions in each case. The amount to be allowed for this purpose must depend upon the difficulty of organizing the project, the degree of ability and amount of time required. The amount properly allowable may be much more difficult to ascertain than some of the other amounts which commissions must determine, as, for example, the fair value of the physical property or operating expenses. Nevertheless, an estimate can and should be made of the amount necessary in order to secure and properly compensate this kind of service.

WORKING CAPITAL

The feeling that capitalization should correspond to physical value of the property has led to some protest against the capitalization of working capital, the fund of ready money and supplies which a corporation must always have on hand in addition to its plant and equipment. The Massachusetts Gas and Electric Light Commission has regularly permitted issuing securities for this purpose, but the Massachusetts Railroad Commission refused to do so, until, in 1909, a special law was passed, providing that street railway companies, to supply themselves with working capital, might issue stock up to an amount not to exceed 5 per cent of the par value of outstanding stock or might issue bonds to an amount to be determined by the Commission.[1] The New York Second District Commission sanctions the issuance of securities for this purpose, and holds that the amount necessary may be determined

[1] Acts of 1909, chap. 485.

by the extent of the operations carried on by the corporation.[1] The Maryland, Missouri, New Jersey, and Indiana commissions have also recognized the propriety of providing adequate working funds by the issuance of securities. The necessity of reasonable working capital with which to provide for the supplies which must be carried in stock, and from which to make advances for materials and wages, is too evident to call for argument. As a part of the investment which is necessary to carry on the business this item should be recognized as one which is properly subject to capitalization.

BONDS AND STOCK—PROPER AMOUNT OF EACH

The commissions controlling security issues must determine not only the total capitalization to be allowed, but also what should be the proportion of bonds to stock and what should be the proper amount of each. In Massachusetts an effort has been made to establish a governing principle by legislative enactment, the law providing that railroads, street railway, gas and electric companies cannot issue bonds in excess of their capital stock.[2] The New York Second District Commission announces that the maximum bond issue which it will approve is determined by the probable excess of earnings over the necessary expenses of operation,[3] and this is to be estimated on "a conservative basis of practical certainty," based upon a comparison of similar plants already in operation. The New York First District Commission follows the same practice, but it has authorized the issuance of stock when it was admittedly very uncertain whether there would be any net income whatever.[4] The New Jersey Commission announces that it will not approve bond or note issues unless there is adequate evidence that the fixed charges can be regularly met, and that the principal can be repaid at maturity. If the securities are to be issued by a plant now operating, the past and current earnings will be a relevant consideration. Where the company is newly projected, bond or note

[1] Application of Rochester, Corning & Elmira Traction Co., P.S.C. Reports, Second District, New York, I, 166.

[2] Massachusetts Acts of 1908, chap. 620, sec. 1, and Revised Laws, 1902, chap. 121, sec. 12.

[3] Public Service Commission Reports, Second District, New York, I, 167.

[4] *Ibid.*, First District, New York, V, 22.

issues will not be approved beyond an amount upon which it appears that with average good management the fixed charges can be met.[1] The Commission states that while it will endeavor to be assured that stock issues will represent property commensurate with the par value of the stock issued it "does not feel obliged to be assured of the probability of returns upon stock as it does in the case of the proposed bond issues." The California Commission severely condemns constructing properties entirely from the proceeds of bond issues[2] and specifies 75 per cent of the total capitalization in the form of bonds as the limit for healthy capitalization.[3] The Wisconsin Commission expresses its opinion that bonds ought not to exceed 75 per cent of the plant;[4] but it has, nevertheless, in many cases authorized greater bond issues than this.

To make an absolute rule uniformly applicable as to the proper proportion of bonds is of course impossible, owing to differences in conditions. Ordinarily the construction of a property entirely by the proceeds of bonds should not be permitted, for this practice leads to insecure bonds, receiverships, a lack of responsibility upon the part of shareholders and other evils. But probably in most cases of sound enterprises, bonds could without any grave danger be issued in amounts greater than are permitted in Massachusetts. The principle followed by the New York and New Jersey commissions is a safe and proper one, in so far as the earnings which are "reasonably certain" can be properly estimated. The principle is that if no bonds are issued upon which the interest would exceed the amounts reasonably certain to be earned, insecure investments and foreclosures will be prevented. Great care should be taken by the commissions that bonds are not permitted in unduly large amounts, since an issue of bonds bearing the approval of a state commission will normally secure a ready sale without careful investigation by investors, even though such issue be so excessive

[1] New Jersey Board of Public Utility Commissioners, Conference Order No. 7 and Conference Ruling No. 13.

[2] Report of California Railroad Commission, 1912–13, p. 309.

[3] Opinions and Orders of California Railroad Commission, Decision No. 578, II, 618.

[4] Personal letter to author, March 3, 1914.

as to lead to future receiverships. While stock should not be authorized except in proper relation to the value of the assets owned or to be obtained, and the prospects of the enterprise, it is not essential that a commission should insist upon the same degree of assurance of a return upon the stock as upon the bonds. For stockholders forego the right possessed by the bondholders to claim a definitely fixed rate of return, in order that they may have the possibility of receiving a larger rate.

SALE OF SECURITIES AT LESS THAN PAR

If the primary purpose in regulating securities is to prevent stock watering, should not the commissions refuse to permit securities to sell at less than par, since if securities are sold at less than their face value the amount of securities outstanding becomes greater in amount than the amount of capital actually invested in the enterprise?

The policy in Massachusetts differs from that of most other states in the treatment of this problem. For many years the laws of Massachusetts and the decisions of the Massachusetts commissions have insisted that stocks should not be sold at less than par. The law also forbids gas companies to sell bonds at less than par, and the Gas and Electric Light Commission and the Railroad Commission have for years discouraged this practice. It has been the policy of the state not only to prohibit the sale of securities at less than par, but also by the use of the "auction clause" and similar arrangements to force them to sell above par whenever possible. The policy followed by most of the commissions is to require stocks to sell at par, but to permit bonds to be sold at a discount. The Wisconsin and Indiana commissions, acting under direction of the state law, require that stock be issued at par, but permit bonds to be sold as low as 75. The New York Second District Commission requires stocks to be sold at par as required by law, but does not make this requirement concerning bonds, which may be sold at a lower price. It says: "The Commission will consider the price at which bonds can be sold and will allow their issue at a discount below par if their market value is not sufficient to allow them to be sold at par." The New Jersey Commission

permits bonds to be sold as low as 80, but insists that stock must be sold at par; or if stock is exchanged for property the property must have a cash value equal to the par value of the stock.[1] The Missouri and New Hampshire laws require stock but not bonds to be sold at par. The Missouri Commission has approved the sale of bonds as low as 70.[2]

The Maine Commission concedes that the requirement that stocks must issue at par may not always be applied to companies already established, but insists upon its application to new projects. It says:

> But we see no reason why, when a new utility is being financed and all stockholders have an opportunity to come in on the same terms, certificates of stock should not mean precisely what they say; in other words, should not speak the exact truth. No one is then deceived. . . . . On the other hand, if the stock is sold at less than par, the balance sheet of the corporation is likely to be misleading from the start. . . . . In the meantime the stock changes hands. . . . . Then, if a question of rates arises and is adjusted, as it must be, on the actual value of the plant, such stockholders are likely to realize for the first time that their stock does not represent what it purports to represent.[3]

Some of the commissions go even farther and regularly authorize the sale of both stocks and bonds at less than par. The Ohio, California, and Georgia commissions permit this. The California Commission, in the case of new enterprises, generally authorizes the sale of securities at about 80, and in the case of established enterprises, at a price varying between 85 and 90.

Whether securities should be permitted to be sold at less than par must depend somewhat upon the general policies governing a commission, and, particularly, its principles of rate-making. If the amount of securities authorized is to be taken as the basis for rates, then it is apparent that securities should not be sold at less than par. To permit securities to sell at less than par and to base a rate to the consumer upon par value of securities outstanding would of course be unthinkable. For this reason,

[1] New Jersey Board of Public Utility Commissions, Conference Order No. 7 and Conference Ruling No. 13.

[2] Missouri Public Service Commission Reports, Vol. I, Advance Sheet No. 2, p. 325.

[3] Application of Black Stream Electric Co., Public Utility Reports, 1915, C, p. 362.

Massachusetts has probably been justified in requiring that securities be sold at not less than par, since the basis for rate-making in that state appears to have been the amount of securities previously authorized by the commissions. But none of the other commissions has used the securities outstanding as the basis for rates. Under such circumstances are they justified in permitting securities to sell at less than par?

Under certain conditions, it may prove highly desirable that a utility should be given permission to sell its stock at less than par. To require all stock to sell at par may mean that the public will be deprived of service which it ought to have, for a company which is unable to sell its stocks at par could not issue new stock in order to add to its equipment or to construct extensions, and it might be so situated that further bond issues would be unwise or impossible. Under such a rule the company which has not been able to pay the going rate of dividends may find it extremely hard to secure additional funds with which to rehabilitate itself. The policy further might lead to unsound finance by tempting a corporation to borrow funds with which to maintain its dividends, in order that the market price of its stocks might not fall below par. It is claimed that all these results have been produced in Massachusetts. Likewise, there are circumstances under which it may be wise to permit the issuance of bonds at less than par. Frequently authorization is asked for bonds which are a part of a mortgage issue, the terms and rate of interest of which were specified at the time the mortgage was placed upon the property, and, as is well understood, the price at which bonds sell is largely a matter of the rate of interest which they bear.

Obviously the foregoing objections to requiring stock to be sold at par do not hold when the corporation and the project are new. Under such circumstances, when the situation is not complicated by the fact that the company is already established and perhaps overcapitalized, its securities outstanding, and its earnings known, the position taken by the Maine Commission that stocks must sell at par is not open to serious criticism. But with old utilities whose securities cannot be advantageously sold at par, a commission should simply see to it that securities sell at the best

possible price which can be obtained for them. Thereby it can prevent the issuance of more securities than are reasonably necessary for a given purpose; whereas it does not prevent desirable additions or improvements to existing properties.

But if bonds are to be sold at less than par, how is the money to be obtained with which to redeem them at par when they mature? Both of the New York commissions require that bond discounts shall be charged to a special account, that annual payments shall be made to this fund, so that the discount will be completely wiped out by the time the bonds mature.[1] The New Jersey,[2] Missouri,[3] Maryland,[4] California,[5] and Illinois[6] commissions also follow this practice. But several of the new commissions, including those of Ohio and Georgia, make no such requirement. The Wisconsin Commission does not uniformly require it. In this clearly these commissions are at fault. The amortization of bond discount is a sound principle. For the discount on bonds simply represents a portion of the interest payment. Bonds of sound enterprises, under normal circumstances, can be sold at par if the interest rate be properly adjusted. If it is so fixed that they sell at less than par, the discount simply represents a deferred interest charge the payment of which is postponed until the bonds mature. This discount, however, is simply a payment for the use of money; it is therefore in the nature of interest and should be converted into an annual interest charge, as it is where amortized. If such sum is not set aside out of earnings, it must in some way be thrown as a charge upon the business when the bonds mature, which means that the full interest charge is not provided for each year during the life of the bond issue. It may be objected to the amortization requirement that it compels the consumer to pay a higher rate than if

[1] Public Service Commission Reports, First District, New York, III, 51. Also Order in case No. 4140, Public Service Commission, Second District, New York.

[2] State of New Jersey, Board of Public Utility Commissioners, Conference Order No. 7 and Conference Ruling No. 13.

[3] Missouri Public Service Commission Reports, Advance Sheet No. 3, Vol. I.

[4] Uniform System of Accounts, Maryland Public Service Commission, June 12, 1911.

[5] Report of Railroad Commission of California, 1912–13, p. 324.

[6] National Telephone and Telegraph Company. Public Utility Reports, 1915, A 875.

there were no such sum to be set aside annually out of earnings. However, if the rate of interest carried by the bonds were so adjusted that the bonds would sell at par, presumably the annual fixed charges upon the property would be higher than if this were not done, with the same consequence of higher rates to consumers. In other words, the annual payments to the amortization fund are only payments to the interest funds in disguised form.

REORGANIZATIONS

As is well known, financial reorganizations are ordinarily accompanied by an increase in capitalization, but with a decrease in the bonded indebtedness and other obligations upon which fixed charges must be met. An increased amount of preferred stock, income bonds, or some such security, is substituted for bonds and obligations bearing a fixed interest charge. In private corporations this procedure may not be open to serious objection, since if the fixed charges are reduced the company may emerge from danger even though heavily overcapitalized. Does the same statement hold true of public utilities? The laws in a few of the states provide that in reorganizations the capitalization shall not exceed the value of the property involved. But most of the laws simply place recapitalization under the control of the commissioners by requiring that all securities issued shall obtain the approval of the commission, but without giving specific instructions as to the policy to be followed in reorganizations.

In the Third Avenue Railroad case, before the New York First District Commission, the company maintained that the rule of law was well established that in reorganizations the reorganized company might issue securities in amounts equal to the previous capitalization. The Commission refused to recognize this principle, and maintained that in reorganizations it would be improper for the Commission to approve the issuance of securities upon which it was improbable that returns would be earned.[1] In rejecting the claim of the company the Commission said:

> A necessary corollary of this theory is that capitalization need have no relation to value. If once a company is started and its securities carefully issued . . . . an equity would be created which would give any successor company

[1] Public Service Commission Reports, First District, New York, II, 97 and 381.

purchasing the property at foreclosure a perpetual right to issue stocks and bonds to the same amount regardless of what happens to the property. The original company might allow the property to decay, it might declare dividends out of capital, it might abuse every corporate privilege and lose 90 per cent of the original investment, and yet the purchasers could reasonably insist that this Commission should approve the issuance of securities equal in amount to the stocks and bonds issued by the original company. It violates the sound principle that capitalization should have some direct relation to the value of the property it represents.[1]

The New York Second District Commission has taken the position that in reorganizations the capitalization must be scaled down to correspond to the value of the property owned. The Commission maintains that the mere fact of judicial sale or reorganization indicates the existence of an excessive capitalization, that the purpose of a reorganization should be to bring the capitalization down to a proper basis, and that in recapitalization stocks and bonds may be issued only to the amount of the fair value of the property.[2] The Missouri Commission takes a substantially similar position. The Cassville and Western Railroad Company had before going into the receiver's hands issued $100,000 in stocks and bonds. In reorganization proceedings it petitioned the Commission for permission to issue securities in a like amount. The Commission, however, took the ground that securities were properly issuable only in amounts to correspond with the "fair present value" of the property owned, which the Commission estimated at $60,000.[3] The California Commission has emphasized the importance of earnings as a factor in determining the proper capitalization in reorganizations. The Citrus Belt Gas Company asked permission to issue $812,397 in obligations in addition to $440,000 capital stock. This was greatly in excess of the total capitalization of the

[1] The company appealed from the decisions of the Commission and the case was decided by the Court of Appeals adversely to the ruling of the Commission. This decision rested upon the fact that a section of the Stock Corporation law, which gave to corporations freedom in the matter of recapitalization, had not been repealed by the Public Utility Commission law. This statute was repealed by the next legislature, so that the Commission is now free to follow the policy indicated in the Third Avenue case.

[2] Application of the Genesee County Electric Light, Power and Gas Company. Public Service Commission Reports, Second District, New York, II, 443.

[3] Second Annual Report, Missouri Public Service Commission, p. 84.

predecessor bankrupt concern, the San Bernardino Valley Gas Company. The Commission said:

> If the San Bernardino Valley Gas Company could not pay interest on $589,700 of obligations, certainly the Citrus Belt Gas Company, with the same properties, cannot in reason be expected to earn interest on the same amount of obligations and on $225,696 in addition. . . . . In behalf of this proposed plan of reorganization it was urged by a witness for the applicant that it merely desired to pay its debts. . . . . In reality this proposal does not so much mean that the company intends to pay its debts as that it intends that the public shall pay them.[1]

The Commission held that "a proper and satisfactory reorganization" would permit issuing obligations of approximately $375,000, since the earnings would justify, "with a proper degree of safety," fixed obligations only to this amount. The remainder of the claims against the old concern were authorized to be paid by $200,000 of the capital stock of the new company.

The principle developed by the New York First District Commission, and applied by other commissions that capitalization in reorganizations should be based on the value of property and earnings, is, if reasonably applied, essentially sound. It may be objected to the scaling down process that injustice is worked upon those who hold the old securities and who are compelled to accept a lesser number or smaller par value of the new. But certainly it cannot be said that any injustice is done to the bondholders, for in any case they are protected only by the value of the property pledged as security for their bonds and by the earning capacity of the property. Likewise, the scaling down does not necessarily involve injustice to the stockholders, as their equity in the property cannot exceed the difference between the value of the property and the bonds and other obligations against it, and their income cannot exceed the difference between total earnings and operating and fixed charges, regardless of the par value or number of their shares. Upon this subject, the New York Second District Commission says:

> What the stockholder should have is a certificate which entitles him to his proper proportion of the dividends which the new corporation may thereafter earn and declare, and to his proper proportion of the proceeds of the sale of the

[1] Opinions and Orders of the California Railroad Company, II, 734.

assets of the corporation, if it should be dissolved and its affairs closed. These are all it is possible for him to get, and he gets precisely the same sum in either event, whether his certificates be marked $1, $100, or $1,000, provided all the other certificates are marked for the same proportional interest in the corporation.[1]

Of course, under some circumstances one might be able to sell two certificates of $100 par value each in a reorganized company for more than one certificate of $100, although the one represents the same share in the ownership of the property as the two. It is partly because of this fact that the tendency to overcapitalization exists, and one purpose of regulating securities is to prevent the evils of excessive capitalization which arise from this fact. But this plea is of no more force in the case of reorganizations than in the case of original projects. Assuming that the capitalization of the bankrupt company is so great that earnings based upon a fair return on the value of the property will not suffice to provide properly for interest and dividends, recognition by a commission of this old capitalization as the proper basis for the new would probably mean that the commission would assist security holders in the defunct company to unload their losses upon others. For the new securities carrying the commission's approval could probably be more readily disposed of, and on more advantageous terms, than the old ones of the bankrupt corporation.

While the new commissions cannot hope to undo all the evils of excessive capitalization issued prior to the era of regulation, it is certainly evident that when capitalization is so out of proportion to earning capacity and value of the property that insolvency and reorganization must result, the time has arrived for the application of the pruning knife.

OBLIGATION OF THE STATE TO AUTHORIZED SECURITIES

Perhaps the most important question arising in connection with the control of security issues is whether the approval of securities by a commission implies that in the future a charge to consumers will be permitted which will produce a fair return upon such securities. Several commissions have explicitly placed

[1] Public Service Commission Reports, Second District, New York, II, 483.

themselves on record as not considering themselves under obligations to permit the charging of a rate which would afford a proper return upon securities approved by them. The California Commission says that in approving securities it does not, and cannot, guarantee the financial success of the enterprise.[1] The New York Second District Commission says that its approval of stocks and bonds cannot be taken as an absolute guaranty for them; that while it will not approve securities unless it believes the property will have a fair chance of business success, yet it does not thereby guarantee the project as a safe one. The New Jersey Commission states:

> Nor does such approval by this Board of such proposed issue of securities carry or imply any confirmation of the business or financial standing of the issuing corporation as a whole. . . . . No statute and no administrative process, however, can relieve the investor of the obligations of prudence and vigilance. At best they can but aid him in furnishing some grounds for the exercise of intelligence and judgment.[2]

The Missouri Commission quotes with its approval the decision of the New York Second District Commission that

> the Commission should satisfy itself that . . . . the venture will be likely to prove commercially feasible, but that it should not undertake to reach and announce a definite conclusion that the new construction or improvement constitutes a safe or attractive basis for investment.[3]

The newly established Public Service Commission of Massachusetts has recently rendered a noteworthy opinion, indicating that it takes a different attitude and that it expects to protect the securities authorized by the state, by permitting such charges to consumers as will yield a fair return upon them.[4] The Vermont Commission apparently adopts the same principle. Beginning in 1910 the Passumpsic Telephone Company had issued, with the Commission's approval, a considerable amount of securities for the purpose of buying competing telephone plants, many of which were

[1] Report of the California Railroad Commission, 1912–13, p. 308.

[2] New Jersey Board of Public Utility Commissioners, Conference Order No. 7, and Conference Ruling No. 13.

[3] First Annual Report, Missouri Public Service Commission, p. 66.

[4] Middlesex and Boston Rate Case, Report and Order, Massachusetts Public Service Commission, 1914, p. 553. For description and comment see note by the author, *Quarterly Journal of Economics*, August, 1914, p. 840.

soon scrapped, as they represented duplications of the Passumpsic company's property. In 1914, an effort was made to reduce the telephone rates. The Commission found that if the charges upon these securities were to be met, rates could not be reduced, and held

> The majority of the present Commission cannot but feel that the authorization of the stock issues for the purposes for which they were used should never have been permitted, but as the state has sanctioned these issues and the state's sanction has been acted upon, the majority cannot see its way clear to do anything that will change or avoid the former action of the state.

The Commission therefore refused to lower the rates.[1] While the principle developed by the Massachusetts and Vermont commissions gives the advantage of security to the corporation and its stock- and bondholders, it has serious disadvantages. The cost of constructing a utility plant today might be much less than the cost when the plant was actually constructed on account of a cheapening of labor and materials. But under the Massachusetts theory the public must continue to pay a rate which will provide a fair return upon the amount of securities originally issued to build the plant. Investments when honestly and prudently made are not exempt from the dangers of subsequent ill fortune and disaster. But a strict application of this principle would throw the burden of the bad fortune upon the public, since through its officials it approved the investment and securities. Under some circumstances, in dealing with corporations which were overcapitalized prior to the establishment of regulation, it would be found difficult indeed to provide for a proper return upon the new securities authorized by the Commission without also permitting a return upon the excessive capitalization which was brought about without a corresponding investment prior to the establishment of public control. For the state to guarantee investments in utility securities, while it exercises little control over the actual administration of corporation affairs, appears to be a dangerous procedure. Approval of securities by a commission representing the state should simply indicate that they are issued for purposes properly chargeable to capital account, that they are not issued for these purposes beyond

[1] Vermont Public Service Commission, Reports and Orders No. 340. In re Addison and Panton Telephone and Telegraph Company, *et al.*

the amounts reasonably necessary, that the corporation obtains assets in proper relation to the amount of securities issued, and that there is good reason to believe that fixed charges upon bonds and notes can be met. Beyond this, a commission's approval of securities should not in any sense be a guaranty of them.

In the regulation of capitalization the state commissions confronted an entirely new problem. The courts had established the fundamental principles regarding the valuation of utility property and rate-making. The path of the commissions in dealing with these subjects had therefore been well prepared. But the courts had never been called upon to lay down principles regarding the control of capitalization. In this field the commissions are doing pioneer work; a body of well-defined principles and precedents concerning utility capitalization is being worked out by the various commissions. While the wisdom of some of the commission rulings may be questioned, as a whole their work is hopeful. It is certain that adequate regulation, such as the commissions are endeavoring to establish, will render impossible the sort of financial jugglery and manipulation which in the past has characterized the management of many utilities, and of which the evil results have fallen largely upon the general public.

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